

## ANALYSIS OF ORIGINAL BILL

Author: Karnette Analyst: Colin Stevens Bill Number: SB 1788

Related Bills: See Legislative History Telephone: 845-3036 Introduced Date: 2/18/98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Enhanced Oil Recovery Credit/Exclusion/Taxpayer Elect Each Year Which Applies

### SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would create an exclusion from income for the sale of oil or gas that is produced from a recovered inactive well, as defined. Taxpayers would be required to elect annually between claiming this exclusion and the existing state enhanced oil recovery (EOR) credit.

### EFFECTIVE DATE

This bill would become effective immediately upon enactment and would apply to taxable and income years beginning on or after January 1, 1998.

### LEGISLATIVE HISTORY

AB 703 (1995/96), SB 38 (Stats. 1996, Ch. 954)

### SPECIFIC FINDINGS

**Existing federal and state laws** provide that gross income includes all income from whatever source derived, including compensation, business income, gains from property, dividends, rents, interest, and royalties, unless it is specifically exempt. Exempt income includes amounts received from certain death benefits, gifts and inheritances, compensation for injuries and sickness, qualified scholarships, educational assistance programs, foster care payments and amounts received under the German Act Regulating Unresolved Property Claims. However, federal and state laws deny deductions allocable to certain activities that are exempt from tax.

**Federal law** allows taxpayers an EOR credit, which is combined with several other credits to form the general business credit. This credit is 15% of the taxpayer's qualified EOR costs, which are defined as amounts paid or incurred for qualifying tangible property which is depreciable or amortizable and an integral part of a qualified EOR project, qualifying tertiary injectant costs, and

### DEPARTMENTS THAT MAY BE AFFECTED:

\_\_\_ STATE MANDATE

\_\_\_ GOVERNOR'S APPOINTMENT

#### Board Position:

\_\_\_ S \_\_\_ O  
\_\_\_ SA \_\_\_ OUA  
\_\_\_ N \_\_\_ NP  
\_\_\_ NA \_\_\_ NAR  
\_\_\_ X \_\_\_ PENDING

#### Agency Secretary Position:

\_\_\_ S \_\_\_ O  
\_\_\_ SA \_\_\_ OUA  
\_\_\_ N \_\_\_ NP  
\_\_\_ NA \_\_\_ NAR  
DEFER TO \_\_\_

#### GOVERNOR'S OFFICE USE

Position Approved \_\_\_  
Position Disapproved \_\_\_  
Position Noted \_\_\_

Department Director

Gerald H. Goldberg

3/19/98

Agency Secretary

Date

By:

Date:

qualifying intangible drilling and development costs.

The **enhanced oil recovery credit** is allowed on costs connected to a qualified EOR project that involves the application of a tertiary recovery method, which is expected to result in a significant increase in the amount of crude oil recovered. Federal law provides various rules regarding eligibility for the credit and interaction with other tax provisions.

For taxable or income years beginning on or after January 1, 1996, **state law** allows a credit for a qualified EOR project equal to one-third of the credit allowed under federal law. The federal rules apply with specific modifications.

The **state EOR credit** specifies that the credit may not be claimed if the taxpayer does not qualify for a specified depletion allowance under federal law. Essentially, retailers, certain related parties, and refineries whose output exceeds 50,000 barrels on any day of the year are excluded. A taxpayer must elect on the original return to have this section or another code section apply if costs of property qualify for any other credit. Any excess credit may be carried over for up to 15 years. This credit may not reduce the tax below tentative minimum tax for AMT purposes.

Federal and state rules allowing taxpayers to make various elections are set forth in statute, regulations, case law, tax forms, and instructions. Generally, elections must be made on the original return by the due date (including extensions of time) of the tax return for the first year for which the election is effective. Although returns can generally be amended at any time within four years from the time prescribed by law for filing the original return, elections generally may not be revoked without the prior consent of the FTB. The FTB follows the judicially created "doctrine of election" and seven factors developed by the Internal Revenue Service (IRS) to determine whether to grant a request to change or revoke an election. Finally, some elections are statutorily irrevocable.

The courts have held that elections required to be made "on the return filed for the year" must be made on the "original" return, preventing taxpayers from claiming these credits on amended returns. If the taxpayer fails to claim a credit on the original return, that failure precludes the taxpayer from filing an amended return to claim the credit.

Under the PITL and B&CTL, **this bill** would allow an exclusion from income for the sale of oil or gas that is produced from a recovered inactive well, as defined. Taxpayers entitled to claim the existing state EOR credit would be required to elect between claiming that credit and this exclusion. This exclusion would apply for the first five consecutive taxable or income years beginning with the year in which production resumes.

#### Policy Considerations

Both the federal and state EOR credits provide a phaseout of the credit based on the price of oil adjusted for inflation. The exclusion in this bill would not include a phaseout based on increases in the price of oil. On the other hand, a phaseout would lessen the benefit of the exclusion from income.

The existing state EOR credit is allowed only to independent producers, who produce limited quantities of oil. This bill would allow the exclusion to any taxpayer who has production from a recovered well.

This bill would allow a taxpayer to make a separate election each year for each well on whether the taxpayer would claim the exclusion or the state EOR credit. This approach could create complexity for taxpayers and for department staff. As drafted, the taxpayer could claim the credit for the year of expense (when there is no income to report from the recovered well.) The taxpayer then could claim the credit carryover against other income while claiming the exclusion in future years.

#### Implementation Considerations

The definition of a "sale" is unclear. Clarification regarding the following points would assist the department in implementing this bill:

- Since oil may be sold at a number of different points, sold as raw crude, semi-refined, or refined into a finished product (e.g. gasoline), it is unclear to which sale the exclusion would apply.
- Taxpayers often trade oil produced in one oil field with production from another field in another state owned by a different company. Under this scenario, it is unclear whether this exchange would be treated as a "sale" under this bill.
- If a trade does constitute a sale, it is unclear if the producer who has exchanged oil from another state for oil produced in California would qualify for the exclusion based on the oil exchanged for and extracted from California.

This bill does not define the term "incidental to testing of the well." A definition for this term would help to prevent disputes between taxpayers and department staff.

#### Technical Considerations

Because of the significant consequences for taxpayers who fail to make elections or desire to change elections, changes have been made recently to other state incentives to remove election requirements by substituting language providing that taxpayers may qualify only for one tax incentive for a given activity or cost. Department staff is available to assist the author's office with amendments to resolve this concern.

The B&CTL exclusion incorrectly references the PITL section in describing the credit taxpayers may claim instead of the exclusion.

Both the amended version of the EOR credit and the proposed exclusion presume that a taxpayer who qualifies for the EOR would qualify for the exclusion for recovered wells and vice-versa. However, that is not necessarily the case. For example, the existing state credit is allowed only to independent producers (those whose output is under 50,000 barrels per day) while this bill would allow an exclusion to any producer of oil or gas who begins production from a recovered well. However, it is also possible that a taxpayer could use tertiary injectants (qualifying for the EOR credit) in a well that is not considered a recovered well for purposes

of this bill. Therefore, it may be best if the language clarified that, where applicable, the taxpayer should choose between the EOR credit or the proposed exclusion.

#### FISCAL IMPACT

##### Departmental Costs

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are not expected to be significant.

##### Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in revenue losses as shown in the table.

Estimated Revenue Impact of SB 1788 As Introduced 2/18/98 [In Millions]		
1998-99	1999-00	2000-01
(\$3)	(\$3)	(\$3)

The bill would be effective for income/taxable years beginning after December 31, 1997, with enactment assumed after June 30, 1998. Losses would be largely under the B&CTL.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

##### Tax Revenue Discussion

The revenue impact of this bill would be determined by (1) the number of idle wells that otherwise would return to production and under this bill also meet specified conditions to be "recovered inactive wells" for which taxpayers elect to exclude any income from the sale of oil and gas, (2) the volume of oil and gas production from these wells, (3) the price per barrel, and (4) the potential offset of the EOR credit if any of the same wells are EOR projects. (Only independent producers are eligible for the EOR credit for EOR projects.)

All producers have inactive wells. In California, the Department of Conservation, Division of Oil and Gas (DOG), has responsibility for regulating idle oil and gas wells. Based on information furnished by DOG, idle wells in California as of late 1997 totaled approximately 19,400. DOG categorizes inactive wells by period of inactivity as follows:

Number of Inactive Wells In California as of Late-1997 By Number of Years Inactive			
<u>5-10 Yrs</u>	<u>10-15 Yrs</u>	<u>15 Yrs +</u>	<u>Total</u>
8,841	5,516	5,020	19,377

A relatively small percentage of idle wells return to production. The longer a well remains idle, the less likely it will return to production. Returning to production a well that has been inactive for a period of years requires an investment of several thousand dollars.

Industry contacts suggest incremental oil and gas production from recovered inactive wells is not likely to reach even 1% of average barrels per day production. In California, average barrels per day of crude oil production are roughly 950,000. Production moves up or down relative to the price per barrel. The current per barrel price is \$8.25. The average price in recent years has typically ranged from \$12 to \$13.50 per barrel.

Assuming (1) incremental oil and gas production from recovered inactive wells is 0.75% of average barrels per day production in California, (2) an average per barrel price of \$12, and (3) a tax rate of 8.84% would result in revenue losses on the order of \$3 million. It is not possible to predict if any recovered inactive wells would also otherwise qualify as EOR projects. DOG estimates about 30% of idle wells are held by independent producers. For this estimate, we assume only a minor offset of projected losses by foregone EOR credits by independent producers (the tax expenditure estimate for total EOR credits is on the order of \$2 million annually).

#### BOARD POSITION

Pending.